

# Picking Up the Pieces – Casualty Loss Deductions After the Hurricanes

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**I**n the past couple years, the South was hit with a series of hurricanes. Alabama was visited by Hurricane Ivan in 2004, then Dennis and Katrina in 2005. These storms had a tremendous impact on Alabama's forests, causing hundreds of millions of dollars in timber destruction. Trees had tops broken out; they were blown over, and many were shattered beyond any further use. Thousands of families had their timber investments wiped out, devastating retirement plans and college funds. Then to top it off, these landowners hear that very little of the loss is deductible from their income taxes. What can a landowner do?

The federal casualty loss deduction rules are complicated and full of loopholes and booby traps. (See "Tax Impacts of Hurricane Ivan," *Alabama's TREASURED Forests* magazine, Fall 2004.) The basic principles seem simple. If property is damaged or destroyed by a "single identifiable event" such as fire, windstorm, ice, flooding or theft, then the difference between the value of the property before the damage and its value immediately after the disaster is the casualty loss, BUT...

Any casualty loss deduction is limited to the basis in the damaged property. Basis is the actual cost of the property to the taxpayer. Basis comes from three sources. It is the allocated cost of the property when it was purchased, the fair

market value of an inherited property on the day of death (or probate), or the cash cost of improvements to a property (such as building a house or planting trees). Most forestland owners have a basis in their timber that is related to either the value of trees when they bought the property (as reflected in the purchase price of the tract), or the value of the trees on the day they inherited the property. Trees planted before 1980 may have some basis related to tree planting costs, but most landowners who planted after that year used the reforestation tax credit and amortization that reduces the basis to zero.

According to recent Internal Revenue Service (IRS) rulings, when there is a casualty loss, the loss is limited to the total basis of all timber on the tract, not just the basis of the trees actually damaged.

Many landowners have complained that limiting the loss to the basis seems unfair. A naturally regenerated stand of hardwoods that is wiped out by a hurricane may have been worth \$2000 per acre before the storm and worthless afterwards. Because the stand was naturally regenerated, there is no basis. So instead of deducting the \$2,000 loss, the IRS rules that there is no loss.

The IRS logic is founded on how they handle stock market transactions. If you buy stock at \$10 per share and it runs up to \$60 per share before it crashes to \$0,

your loss is not \$60, but is limited to \$10. The logic is that you cannot lose more than you have invested.

The Alabama Forestry Commission encourages anyone with timber damage to salvage as much as possible, as quickly as possible. By doing a salvage sale, the landowner can receive some income from the property, as well as reduce the hazards of wildfire and southern pine beetle.

If a landowner does not sell any salvage, the casualty loss is simply the basis in the timber on the tract. If the landowner does sell the salvage, the casualty treatment is a two-step process. Step one is the casualty loss deduction, which is limited to the basis in the timber on the property. In the next step, the salvage sale is treated as a capital gains transaction, where it is taxed at a reduced rate. The gain is calculated by taking the salvage sale income and deducting all selling costs, but no basis.

## Reinvesting Salvage Income

You have a disaster and lose your shirt. Then you sell the rags and have to pay taxes on the sale. Many landowners felt this was not fair. In 1980 the IRS instated the "Hurricane Frederick" rule to reduce this problem. Under this rule, now codified as Internal Revenue Code Section 1033, if a landowner uses salvage income to reinvest in similar prop-

erty, the capital gains tax is deferred until the new property is sold.

IRS rules state that the salvage income “gain” must be reinvested into a similar property within two years following the tax year in which the salvage occurred. So, timber salvaged in 2005 must be put back into forests before December 31, 2007. The definition of similar property includes either buying new forestland, or site preparing and replanting the damaged stand or another tract, or buying controlling interest in a timber company. The third option is not available to most

landowners. The salvage income can be used to site prepare and replant the damaged tract, OR buy a new tract of forestland, OR buy cutover land and reforest it.

The basis in the new property would be reduced by the capital gains reinvested. If the cost of reforestation equals the capital gain, the new basis is \$0. If the cost of the reforestation is less than the capital gain, the “excess income” would be taxed at capital gains rates. If the cost of reforestation is more than the capital gain, the extra cost becomes the new basis of the stand. This extra cost does

qualify for the reforestation deduction (see sidebar below).

Many landowners feel dejected when they look at the devastation following a hurricane. However, the forest will recover. By salvaging what you can and reinvesting in reforestation, the value of the forest investment can also begin to recover. Hurricanes are a fact of life in the southern coastal plain, but the productivity and beauty of our forests make the risks worthwhile. Reinvest; restore your “TREASURE.” ♣

## *Reforestation Tax Benefits Improved*

**F**orestry is a long-term investment. People plant trees, looking for a return thirty to fifty years into the future. In forest management, short term is twelve years. Because of that, there are special tax rules that apply to forest management.

It is important to remember that the government wants you to plant trees. Many programs have been established over the years to encourage tree planting. In 2004, the federal government made a major rule change that directly benefits landowners who plant trees.

Let us begin by looking at the old rules. **Prior to October 22, 2004**, anyone who planted forest trees was eligible for an investment tax credit and amortization of the reforestation costs. The benefit was a 10% direct tax credit on the first \$10,000 of reforestation costs. In addition, the landowner was allowed to amortize 95% of the reforestation costs (up to a limit of \$10,000 per year) over seven years. Under these rules, the amortizable amount was deducted over 84 months: 6 months in the first year, 12 months' worth for the next six years, and the remaining 6 months in the eighth year.

Example: If a person spent \$10,000 to reforest a tract, he or she could take a \$1,000 tax credit, and then take a reforestation amortization deduction of \$679 in Year One and Year Eight, and \$1357 for Year Two through Year Seven. Any reforestation cost over \$10,000 per year must be capitalized and added to the timber basis. This excess cost would be recovered when the timber is cut many years from now.

However, Congress changed these rules last year. If a stand of timber was reforested **after** October 22, 2004, the landowner can **directly deduct** up to \$10,000 per year. This law repealed the reforestation tax credit. By allowing the deduction of the reforestation costs in the year in which they occur, the landowner gets an immediate return on his or her investment, instead of waiting over eight years.

Under the old rules, any costs over \$10,000 per year was put into basis and “locked away” until the first timber sale. Now, any costs over \$10,000 per year would be amortized over 84 months, using the same rules as under the old law. This is a direct benefit to landowners who have large tracts to reforest or high site preparation costs.

There is still a quirk in the law that sets the limit at \$10,000 per year per taxpayer. This requires a little financial planning for southern landowners. In most cases, site preparation work in the South is done in the late summer to fall, while tree planting is usually done between January and March. Even if the landowner has a “turn-key” contract, with one vendor doing both site preparation and planting, it would be better for the landowner to split the payment to spread the costs over two years. By paying for the site preparation before December 31, and paying for the tree planting when it is finished in February or March, the landowner can take the deduction in two tax years, thus deducting up to \$20,000 total (\$10,000 per year). Most consulting foresters and many vendors are aware of this tax benefit and would be glad to work with the landowner to make this happen.

The expenses that are eligible under this provision include all site preparation costs (including mechanical work, chemical treatments, and prescribed burning), the cost of the trees or seed to be planted, all planting labor, and the use of post-planting herbicides for herbaceous weed control. In order to take the deduction, you must show cash expenditures for these items. Planting the trees yourself is not deductible, but paying a family member to plant them is allowed. The deduction applies to both natural regeneration and tree planting, both pine and hardwood.

The regulations allow deductions for overhead costs, if you have a consulting forester managing the operation for you. Herbaceous weed control must be done during the first year to be included in this benefit.

One disadvantage of this system is that after the costs are deducted or amortized, the basis in the timber is used up. Later, when the timber is sold, the capital gains tax on the sale will be higher, because of no basis deduction from the sales price. Also, should a casualty occur later, the timber has no basis and thus the loss deduction would be zero.

After being slammed by three hurricanes within a year, many landowners are disheartened and reluctant to replant their damaged timber stands. This new tax break will hopefully encourage timber owners to reforest and maintain the TREASURE that grows in their Forest. ♣